



# Flat or Flattened? A Review of International Trends in Tax Simplification and Reform

FISCAL REFORM IN SUPPORT OF TRADE LIBERALIZATION

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# Flat or Flattened? A Review of International Trends in Tax Simplification and Reform

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## **Flat or Flattened? A Review of International Trends in Tax Simplification and Reform**

Around the globe, tax reform (both policy and administration strengthening) is proceeding apace.

Generally, governments introduce tax reforms to enhance revenue collection and simultaneously improve the environment facing economic agents. Today, more than ever, the inter-relationships between taxation, competitiveness, growth and the underground economy are causing national policy makers to assess the impact of their policies, their neighbor's and their competitor's.

More specifically, tax reforms are aimed at improving the economic environment through simplification of the tax system – eliminating taxes that yield little revenue and which may be costly to taxpayers in terms of compliance (nuisance taxes) and eliminating costly complexities in the taxes that remain.

Whether in the developed, developing or transition economies – some developments are common. In particular, there appears globally to have been a trend over the past decade towards:

- reducing the top rates of personal and corporate income tax with the objective of increasing compliance and revenue, besides impacting on competitiveness and growth;
- merging (or at least, reducing the disparity between) personal and corporate income tax rates – to avoid tax arbitrage and undesired impacts on capital/labor utilization;
- increased reliance on VAT;
- increased pressure to reduce trade taxes; and
- increased tax competition for investment funds (both foreign and national).

Many of these commonalities are the result of trends in the worldwide economy such as: the increased mobility of capital, the expansion of free trade zones, and the expanded use of the internet. The key lessons learned from successful tax reforms around the world include:

- rates should be as low as possible;
- tax bases should be as broad as possible;
- the effective tax rate capital and labor should be similar;
- tax incentives generally do not work in the long run and if they do add to economic activity, they are not worth the cost;
- voluntary tax compliance and its obverse, enforcement, should be simple as well as cheap; and, tax administration modernization is a constant.

In recent years, there has been a renewed focus on the ‘Flat Tax’, which is sparking debate around the world.<sup>1</sup> This paper briefly reviews “what is a flat tax,” what are its perceived strengths and weaknesses, and attempts to assess its impact. The paper concludes that the flat tax is in reality a variant of the trend towards a general reduction in tax rate (flattening) that has tended to focus on individuals and to a somewhat lesser extent, businesses. It is however, a useful intermediate step for the transition countries’ move from a socialist tax system to a more western, income-tax based system.

### **What is it?**

There is considerable confusion amongst both tax professionals and politicians as to what they mean by a flat tax. All, however, agree that ‘Flat taxes’ refer to taxes with a single positive marginal tax rate. Flat rate income taxes, where a single, flat rate is levied on individuals’ income and, in some cases, businesses, are the kind of flat taxes most typically identified with the “flat tax revolution” (*The Economist*, April 2005). These taxes are typically simplified tax systems (STS) that make compliance and administration simpler and easier for both taxpayers and the tax administrations.

Under flat tax regimes, tax credits and exemptions are removed from the system as much as possible so as to ‘simplify’ the system – one of the key attractions. In most countries, the flat tax then has simply two policy levers – the rate and the personal deduction on personal income – to determine the government’s revenue from income tax and to affect the number of taxpayers, economic development, and the progressivity of the tax system.

Typically, a flat tax structure consists of a single ‘flat’ tax rate paid by all those whose income exceeds some personal allowance (assuming that there is one). This structure is therefore progressive up to the level at which the flat and marginal rates coincide. If there is no provision for personal allowance – this may be referred to as a ‘pure’ flat tax. There may also be allowances for certain types of income (for example, some pensions in Jamaica and Estonia) or for family size (by number of children in Estonia and Slovakia, among other countries). The concept may apply to both personal and corporate income, with the broadest systems applying the same rate to all income sources and avoiding the double-taxation of savings. If investments are fully deducted by businesses, the individual and business tax rates are equal, and fringe benefits are taxable, a flat tax may be a type of consumption tax.<sup>2</sup>

Flat taxes can also describe a tax system in which the same ‘flat’ tax rate is applied to

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<sup>1</sup> There are of course other simplification and reform strategies including the dual income tax (used in the Nordic countries and discussed for Japan) and a host of presumptive systems.

<sup>2</sup> The broad-based consumption flat taxes do not tax normal returns to capital as they allow full expensing of capital purchases and no individual income taxation of interest and dividends.

different taxes— personal income tax, corporate income tax and consumption (VAT); these may be referred to as a ‘comprehensive flat tax’ system.. To add to some of the confusion over semantics, the flat tax proposed by U.S. authors Robert Hall and Alvin Rabushka (1981, 1985, 1995), is a flat tax system imposed through an income tax that closely resembles a tax on consumption.

### **Why the trend?**

Simplification of the tax administration is often touted as one of the main drivers of the move toward a flat tax for income and other taxes as well. Advocates for flat taxes argue that beyond simplification and transparency, they can increase investment, increase compliance, bring the shadow economy into the official economy and/or boost labor supply since the marginal tax rates are typically lower than under the pre-reformed systems. Comprehensive flat tax systems may have additional compliance benefits since there is less scope for tax arbitrage. More specifically, advocates of flat taxes on incomes argue that benefits arise from better compliance and positive supply side effects – that revenues rise in a Laffer Curve manner, so that any tax cuts required to lower the marginal rates pay for themselves.

Unfortunately, it is difficult to test the impact of flat rate income taxes on economic growth and on the level of tax revenue (this is discussed in detail below) and so, there is little hard evidence to support this claim. For instance, in Estonia, the first of the recent flat tax ‘revolutionaries’, there was a large increase in GDP growth just prior to the introduction of the flat tax in 1994 (in 1993, growth was 8.2 percent).

### **Who has it?**

Aside from two Channel Islands (Jersey and Guernsey, introduced in 1940 and 1960), Hong Kong (1947, an optional, dual system) and Jamaica (1986) are the countries with the longest standing flat income and/or consumption taxes.

More recently, there has been a renewed interest in flat taxes in the transition countries where western style systems of taxation were first introduced in the mid-1990s, beginning with Estonia in 1994 and quickly followed by 8 other countries. The data in Table 1 below provide a survey of the most “recent flat” tax countries.

Estonia has maintained its relatively low flat tax system on personal income since the mid-1990s. Rates on personal income tax (PIT) in the other transition countries range from a high of 33% in Lithuania (subsequently reduced to 29%), to 12% in Georgia. In 2001, Russia introduced a flat tax on personal incomes, establishing a marginal rate of 13% above 4,800 rubles (approximately \$166 U.S. dollars). Since then, revenues from personal income tax in Russia have risen by 50%, over and above inflation. The Russian reform has been regarded in many quarters as especially successful and undoubtedly has influenced the introduction of a flat tax in several other countries in the region.

Elsewhere, Iraq and Paraguay both recently introduced a flat tax. It is also worth noting that several of the U.S. states have a flat rate income tax (Colorado, Indiana, Illinois, Massachusetts, Michigan and Pennsylvania).

The introduction of the new, relatively low flat tax rates in the transition countries, and the perceived resulting tax competition, in addition to Ireland's low corporate rate, has sparked interest in introducing a flat tax system in several Western European countries (notably, Germany, Norway, Spain and the UK) as well as additional transition countries. Table 2 provides a list of countries with a flat tax and those that have recently discussed flat taxes. As seen there, the flat income tax rates of most of the transition countries are much lower than the tax rates of the Western European countries.

In the United States, there has been interest in the introduction of a flat tax for some 20 years, in large part in an effort to simplify the federal income tax code, although revenue enhancement is also a factor. Currently, there are numerous variants<sup>3</sup>, beginning with the Hall/Rabushka proposal from the mid-1980s. In fact, the Hall and Rabushka "flat tax" proposal is often credited with giving rise to the global resurgence of interest in flat taxes.

Additionally, China has been seriously looking into the flat tax for the last decade and there are some indications that China could also adopt a flat tax of some form in the near future.

### **A Flat-Tax Revolution?**

In the first half of the nineteenth century in the industrialized world, flat tax structures were the norm. Ironically, the first proposals for a 'progressive' income tax structure came from Karl Marx' Communist Manifesto in 1848. Today, however, it is the industrialized countries that retain progressive structures while the former Communist countries favor flat taxes.

Beginning in the early 1990s, there was a resurgence of interest in flat taxes in the transition countries, in large part in an effort to quickly adapt to western styles of taxation. And, a growing number of countries in Eastern Europe adopted a flat tax, putting pressure on many Western European nations to lower their rates. In fact, several European nations (Denmark, Finland, Norway and Sweden) and Japan have turned to the "dual income tax" or DIT) as a means of simplifying their systems.<sup>4</sup>

So, rather than a revolution – as portrayed by many tax practitioners, the trend is perhaps one of reverting to an earlier, simpler tax system.

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<sup>3</sup> In 2005 in the US a bill in Congress introduced the 'Fair tax,' a flat rate income tax on sales (H.B. 25). The proposal would allow generous personal allowances, tax most consumption at 23 percent, and reduce the need for the IRS. Currently, H.R. 5176, the Fair Flat Tax, would replace the current corporate and individual income tax systems with a flatter rate structure that eliminated numerous exemptions and deductions. Replacement of the current system is, however, unlikely.

<sup>4</sup> See, for example. Genser (2006) and Ishi (2006).

## **How a Flat Tax Works**

The basic principle of a flat rate income tax is that all income should be taxed at a single rate of tax for all taxpayers as close to source as possible, regardless of whether it is personal or business income. If savings are not taxed, then the flat tax on personal income is, in effect, a consumption tax with a personal allowance.<sup>5</sup> Such a system means that the individual and business income tax systems would be fully integrated and taxes on interest and dividends are taxed at source (on the businesses). More typically, the flat rate income taxes are characterized by the following principles:

- A low but not necessarily equal tax rate for individuals and businesses
- An increased personal allowance over pre-reform law
- Elimination of additional tax allowances and deductions
- Reduced taxation of capital.

- **Low Rate**

It is argued that, in general, a flat tax with one (low) rate of tax can raise the same level of revenue as from a progressive system with several rates. This assumes that any revenue loss from the rate cut is compensated for by an expanded tax base, increased compliance, reduced avoidance/evasion and reduced disincentives. In practice, this will depend on the rate chosen and the significance of the income tax to total revenue and the relative shares of other taxes.

As described more below, in practice in the flat tax countries, however, different types of income are taxed differently. For instance, in Lithuania, there is a 15% flat rate on royalties, interest and other sources of income. Russia taxes capital income at rates typically higher than wages, and taxes businesses under a separate schedule.

- **Personal Allowance**

There are numerous versions of a flat tax on personal income, but since in most versions a flat rate is combined with a personal allowance, the term ‘flat tax’ is somewhat misleading. These are not flat taxes (they do not integrate individuals and businesses and do not necessarily treat income from capital and from wages consistently), nor are they flat rate income taxes, as there is an implicit “0” tax bracket and one additional tax rate. Combined

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<sup>5</sup> A flat tax that allows expensing and includes one flat rate for business and individuals is more along the lines of the proposals in the U.S. These taxes come closer to taxing consumption as a base in that they effectively exclude from taxation normal returns to capital.

with a personal allowance, it is only the marginal rate that is flat. Namely, the tax is progressive and the average effective rate increases up until the marginal and flat rates are equalized.

In other words, the personal allowance makes a flat rate income tax progressive rather than proportional for a range of incomes, but at higher income ranges the tax become proportional as the effective rate of tax comes closer and closer to the marginal rate of tax.<sup>6</sup>

- **Elimination of additional tax allowances and deductions**

In general, no deductions, credits or reliefs are allowed under the various flat rate tax systems, making the flat tax a simple and transparent system to administer and to comply with. The level of institutionalization of credits, tax holidays, deductions and the like may make the choice of a flat rate tax more difficult politically as getting rid of tax preferences can be more difficult than changing tax rates.<sup>7</sup>

- **Tax treatment of capital**

Developed and developing countries have traditionally treated capital investments and income differently than labor income. Many developing countries have very limited taxation of capital either due to the difficulty to tax capital or because of tax holidays given to companies for investment in order to spur on economic development.<sup>8</sup>

Under the flat tax systems, the treatment of capital is typically more closely integrated with that of wage income. However, the specific treatment of capital varies widely among countries. Russia, for instance, taxes interest and dividends at the individual level under a different schedule than the flat rate income tax; Jamaica, for the most part, does not tax capital gains income at all; Estonia's original flat tax reform retained a generous (but not complete) depreciation of capital.<sup>9</sup> The treatment of capital in flat rate tax systems is important in terms of the potential impacts on saving, investment and economic growth,

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<sup>6</sup> The "X-tax" attributed to David Bradford (1986) is a flat-tax type proposal that explicitly includes a progressive marginal tax rate schedule.

<sup>7</sup> Tanzi and Zee (2001) describe the plethora of deductions, exemptions, and tax holidays that are available even in developing countries. Jamaica and Russia are specific examples of countries that successfully reduced (but not eliminated) numerous deductions and exemptions when they moved to flat rate income taxes.

<sup>8</sup> Bird and Zolt (2005) describe the general treatment of capital in income tax systems in developing countries.

<sup>9</sup> Estonia's 2000 reform reduced the taxation of corporate capital further (Funke, 2002).



but to date, it is difficult to find “typical” treatment of capital in the recent flat rate income tax countries other than a lowering of rates.

### **Impact?**

Debate over the impact of a flat tax structure has been fierce - not only because the stated benefits represent an attractive remedy for administrative and economic challenges which are common to transition economies, but because there is so little hard evidence to support the pro-flat claims. The lack of firm data as well as difficulty in attributing impact is clear from the empirical literature as well as research undertaken for this paper.

Not surprisingly, the debates have been greatest in the transition and Eastern European countries where the most flat tax systems have been introduced – and, in particular, Slovakia’s neighbors, the Czech Republic, Hungary and Poland, where concerns of relative competitiveness are forefront.

More recently, the debate has spread to the western European states, who are also concerned about retaining their competitiveness. Germany and Spain have both formulated proposals for a 30% flat tax on income, while Austria, Denmark, Greece, Finland and more recently, Britain have considered the option.<sup>10</sup> However, for the most part, the West European governments remain committed to the principle of progressive taxation on equity grounds and while none, to date, have introduced a flat tax, most have in recent years reduced both the top rates and the number and complexity of bands.

In evaluating the impact of flat taxes it is important to consider the existing tax system as well as the economy at large – both before and after – and its structure.

For instance, the transition economies tend to collect a relatively small share of their total government revenue from income tax, so lowering the rates has less of an impact than such a move would have in Western Europe, where with its more mature (complex) tax systems a significantly higher share of revenue comes from income tax. For instance, in the new EU member states, PIT accounts for 14.4% of total tax revenue compared with 24.1% for the EU-15, which means that the new EU members have somewhat less revenue performance downside to reductions in income tax rates.<sup>11</sup> Tables 3 and 4 put these relative shares into context by providing information on taxes as a percent of GDP for a summary of 118 countries and income taxes as a share of total taxes for a summary of 57

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<sup>10</sup> The Adam Smith Institute has published two papers on the flat tax. The most recent (Richard Teather) proposes a rate of 20% on personal income with a GBP12,000 personal allowance and the elimination of all other reliefs and allowances. This proposal was adopted by Veritas in their election manifesto.

<sup>11</sup> Also, Slovakia collects 2% of GDP from personal income tax compared to 8% in the UK

countries. These data are taken from the IMF, *Government Finance Statistics* and the World Bank, *World Development Indicators*. As seen in Table 3, the ratio of taxes to GDP for the flat tax countries is not out of line with developed nations around the world and those country's usage of the income tax is near international norms, for the countries in which data are readily available. For developing countries at large, however, both the tax revenue to GDP ratio and the income tax share in total taxes is relatively low. In some countries, such as Georgia, Croatia, and Moldova, the income tax is a very small share of total revenue and GDP.

Besides collecting a lower proportion of total revenue from income tax, the developing and transition countries have a mix of statutory tax rates that are applied under current law. Not all of these rates are low, suggesting that moving to flat rate income taxes could mean a significant decrease in tax rate in some countries. Jamaica, for instance, reduced its top statutory marginal tax rate for individuals from 57.5 percent to 25 percent during its flat tax reform. Russia dropped their top rate from 35 percent to 13 percent.

Additionally, when trying to determine the likely impact of a flat rate income tax, there is a need to consider the relative weights of other taxes in the share of total government revenue. In short, in gauging the impact of a flat system, when setting the 'flat rate' consideration needs to be given to its alignment with VAT or other key taxes such for instance, as the property tax in Hong Kong. (Hong Kong has had an optional flat tax on personal income for decades.)

The remainder of this section briefly reviews the evidence on the impact of flat taxes to date in the key areas where their proponents argue for their introduction. The main lines of revenue and economic impact are:

- Increased administration/compliance: a flat rate tax system with few or no exemptions and deductions is easier to understand, makes it harder to hide income or cheat on deductions, is easier to enforce, and may increase the perceived fairness of the system. These factors could reduce administrative costs and increase (voluntary and involuntary) compliance.
- Reduction in the relative cost of capital: a flat income tax system that lowers the cost of capital by reducing (or eliminating) the direct tax on the return to capital (interest, dividends, capital gains) could increase the level of investment and therefore increase economic growth.
- Reduction in the relative price of saving: a revenue neutral flat tax system that is a consumption based tax, or one in which consumption is taxed heavier than saving (which possibly includes Jamaica and the dual income tax countries), will increase the relative price of consumption and lower the "price" of saving. In theory, this may increase the amount of saving and increase the amount of capital that is available for investment. An increase in the supply of capital should, in turn, reduce the cost of capital and spur on investment. This can lead to higher rates of economic growth.

- Increase in the return to labor: for labor, flat rate income taxes often reduce the top tax rates and therefore may encourage increased labor supply activity (thus expanding taxable income), especially at higher income levels.

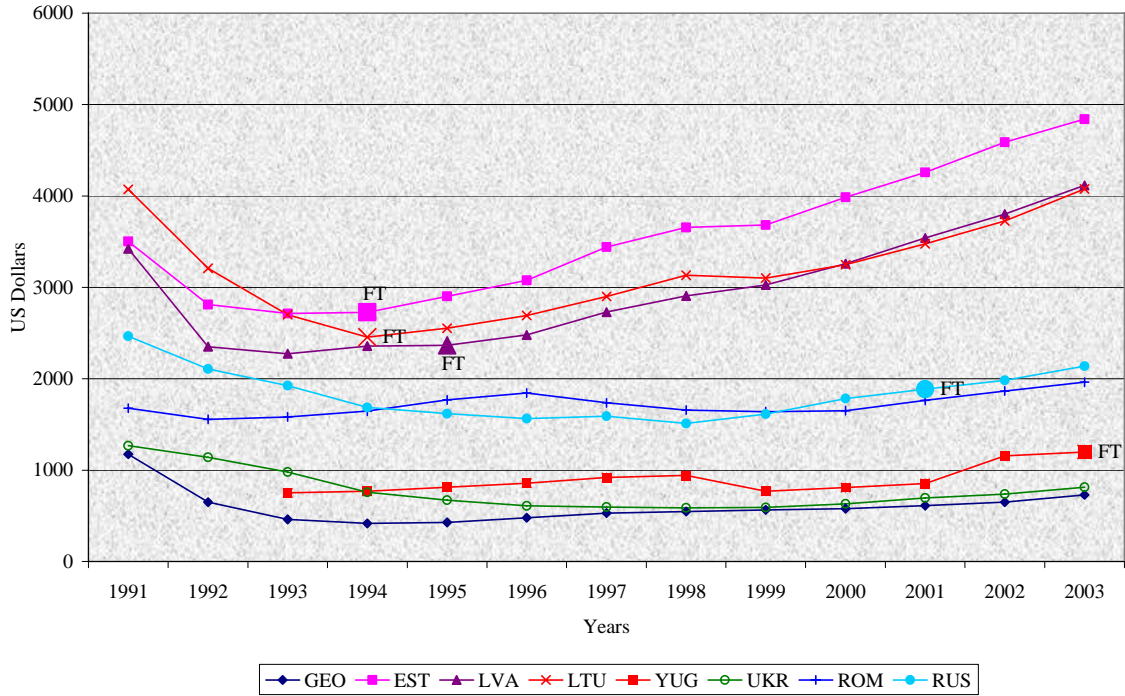
- **Revenue and Economic Impacts**

Supporters of flat taxes argue that in the longer term, increased compliance and economic activity lead to increased revenues. However, the evidence is at best mixed across countries. One way to view the relationship between the introduction of the flat rate income taxes and economic and fiscal performance is provided in Table 5. In that table the flat tax countries are reported with data on annual GDP growth, foreign direct investment and the estimated level of the shadow economy as a share of GDP. Post flat tax reform, the annual growth in GDP is strong for Latvia, Serbia, and Estonia, but less strong for Lithuania, Slovakia, Romania, and Russia. As far as foreign investment, there is growth in FDI post-reform in Estonia, Latvia and Serbia but again, more mundane growth in the first year for Russia, and less growth in Lithuania and Slovakia.

If the flat tax succeeds in reducing compliance costs, then we might expect the shadow economy to shrink as more individuals and businesses come into the tax net. The data available to consistently estimate the shadow economy is difficult to come by—especially for new flat tax countries. In Table 5, for countries where data are available, estimates of the shadow economy pre and post flat tax reform are presented. From this information, it does not appear that these countries witnessed much change in the size of their shadow economies. In addition, Schneider (2005) reports shadow economy estimates for 1999-2003 for groups of countries including the transition countries. His estimate is that from 1999 to 2003, the average size of the shadow economies of this group of countries (East and Central European and Former Soviet Union Countries), grew from 38.1 percent to 40.1 percent.

Figure 1 presents another view of the growth in GDP for flat tax countries. Without controlling for any other factors, this figure tracks real per capita GDP for many of the transition flat rate income tax countries. The trend lines in real per capita GDP do not give overwhelming support to the idea that flat taxes fuel economic growth. In Estonia, Russia, Latvia and Slovakia, GDP growth was on the upswing before the flat rate income taxes were imposed. In the other countries, the flat tax introduction and GDP growth came in the same year. It is difficult to believe that the flat rate income tax could have that quick an impact. Tax revenue as a share of GDP actually fell in Estonia and Lithuania, while increasing in Latvia and Russia post flat-tax reform.

**Figure 1: Real Per Capita GDP For Transition Countries with Flat Taxes**



Source: World Bank, World Development Indicators

Finally, we conducted a more systematic analysis of the growth in GDP and the growth in revenue. We ran a series of panel regressions using the share of individual income tax to total revenues as well as to total tax revenues, as a function of GDP per capita, agricultural share of GDP, manufacturing share of GDP, openness and included time variables, fixed effects and the flat tax dummy. Similar estimations were made using the ratio of corporate income tax to total revenues as well as to total tax revenue. In all the cases we could not find a consistent relationship between the flat rate tax income tax variable and revenue growth.

We did a similar analysis for individual income tax revenue as a function of the flat rate income tax using a time series-cross section (panel) analysis for 40 countries. These countries are a mix of developing, developed, and transition countries. The model takes into account country fixed effects:

$$Tax_{it} = \alpha_o + \beta_1 GDP_{it} + \beta_2 Agric_{it} + \beta_3 Manuf_{it} + \beta_4 Openness + \delta_0 Flattax + a_i + \mu_{it}$$

Both *agriculture* and *manufacturing* are shares of GDP while *openness* is the sum of imports and exports divided by GDP. Flat tax is the flat tax dummy which takes the value of 1 for the years that a country had a flat tax and zero otherwise. The dependent variable

is income tax revenue as a share of total tax revenue and separately as a share of total revenue.<sup>12</sup> In both cases, we find that countries with a flat tax have about a 0.1 percentage point higher level of individual income tax revenue than countries without a flat rate income tax. However, the impact is exactly opposite for the corporate income tax, but corporate tax revenues are much lower to begin with in these countries.

There is some additional empirical evidence regarding the economic success of the flat tax movement. For example, Ivanova et al's (2005) evaluation of the Russian Flat rate income tax states that "A key conclusion (from Russia) is that tax-cutting reforms of this kind should not be expected to pay for themselves by greater work effort and improved compliance".<sup>13</sup> Subsequent IMF analysis of Romania in 2005 concluded that there would be a revenue shortfall due to the flat tax (16%), despite the increase in VAT to 20% and additional increases in excise. Martinez et al (2006) also evaluate Russia's flat rate income tax and find evidence that the labor is not very responsive to changes in net wages that accompany the tax reform.

The empirical evidence on the impact of flat rate income taxes is slowly growing, but it is likely that each country's experience is its own and not generalizable. This is because those relative price changes that affect the economic impacts are specific to each individual country. Slovakia, for example, reports positive impacts of its flat rate income tax. According to the director of Slovakia's Hayek Institute, income-tax revenue is 0.5 percent of gross domestic product larger than predicted by "static" analysis (reported in the Washington Post, Dec. 22, 2005).

- **Compliance**

It is widely claimed that flat taxes will improve compliance and so, reduce a country's tax gap. The idea here is that a flatter, simpler tax system may reduce the value of non-compliance and will also increase the perceived fairness of the tax system. However, the evidence to date is misleading and apportionment of the improvement in the countries cited - difficult. In general, empirical conclusions also differ as to whether higher tax rates discourage compliance. Friedman et al (2000) concluded that higher flat tax rates do not encourage evasion, while Yitzhaki (1974) and others demonstrate that higher rates may increase evasion, but there are other mitigating factors to consider such as penalty rates.

For instance, in several countries, and Russia in particular, the introduction of a flat tax coincided with more general tax reforms. While compliance did improve significantly, it is difficult to substantiate that the improvement resulted from the reform or other changes

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<sup>12</sup> We did a similar analysis for total tax revenue as a share of GDP.

<sup>13</sup> Ivanova, A, M. Keen and a. Kremm, The Russian Tax Reform, IMF Working Paper, January 2005.

in enforcement that were introduced simultaneously. Specifically, the introduction of the flat tax coincided with the introduction of withholding of taxes at source, the introduction of taxpayer IDs, as well as the audit of suspected tax evaders. Martinez et al (2005) find little evidence that the administrative focus of the tax administration in the Russian Federation was responsible for much of the revenue increase.

The level of shadow economies found by Schneider also brings into doubt the impact of flat rate income taxes on compliance. To be fair, for many countries, it may be too early to be able to measure such changes, but in Estonia, for example, he finds an increase in the shadow economy between 1999 and 2003 (we do not have a baseline of the shadow economy for Estonia for pre-reform).

- **Simplification**

More detailed analysis suggests that actual flat tax systems are more complex than the headlines suggest. For example, personal allowances and exemptions complicate collection, and high social security payments in Estonia (33 percent), Slovakia (35.2 percent by employer and 13.4 percent by employee) and Russia (26 percent for employers and 2 percent for employees with incomes over 600,000 rubles, currently about US \$22,000) for example, affect labor utilization. In Hong Kong, the high share of revenues from the property tax supports the island's otherwise low flat tax on income.

For the western world, the culture of 'fairness' tends to prevail over simplification. While the elimination of allowances, deductions and other reliefs that the flat tax would bring provide the main benefits of simplification and transparency – these changes are politically not feasible in the west. So, the introduction of a single flat rate on income tax in Western Europe would carry the entire weight of a political tax reform, with few of the benefits.

Nonetheless, in time, the complexity of the mature western tax systems may merge with the increasingly prevailing view that equity is more readily realized through expenditures than taxation.

Overall, it is possible, therefore, to conclude that the flat tax option is simply an important means to simplify tax structures, and a relatively more attractive one for young tax systems than for mature and more complex systems of the industrial world.

## **The Flat Rate Income Tax in Practice**

As with any macro policy, tax policies need to be developed within the particular circumstances of a country at that particular time. Different countries face different environments and situations and 'No one size fits all' - NOSFA. In this section, we summarize some of the flat rate income taxes in practice.

Of the approximately 20 countries with a flat tax, systems adopted vary significantly. Some of the key characteristics are as follows:

- Low Rate?

Although the literature frequently describes flat tax systems as low, they may not always be low. Lithuania introduced a flat rate on personal income tax of 33% in 1994 - higher than most flat tax proposals under consideration in Western Europe and the United States (recall Table 2).

The scope of the flat taxes (and coverage of the flat tax rate) also varies. Systems may or may not provide for the same rate on all sources of income, including dividends and interest. For example:

- To date, Slovakia is the only country to have adopted a ‘comprehensive’ flat tax system, which it is argued eliminates much of the practice of tax arbitrage.
- Russia has a single low (13%) rate on all personal income, but a different rate for corporate profits (35%) at the time of the reform, and subsequently lowered to 24% in 2002. Capital income is treated under yet a different schedule.
- Combined with other taxes and charges? The flat tax may be combined with different taxes; for instance, Estonia includes social taxes (33%) as well as local income tax. Some systems also provide for separate charges, such as unemployment insurance and health, and variants on the personal allowances, for instance, for additional children. Part of Russia’s reform was to simplify the payroll taxes, but they are administered separately from the personal income tax.
- Hong Kong has a dual, optional system whereby taxpayers can opt to elect to pay a ‘regular’ income tax or flat tax when their obligations reach 16%. In Hong Kong, however, the tax system is strongly supported by a relatively high annual property tax (16%) on the net assessable value of a property (or how much the property could be rented for).
- Hungary has an elective flat tax system for small businesses which includes VAT but not social taxes, which makes it a more selective type of flat tax.

- Personal allowances

As noted above, the second key lever – personal allowances – provides for progressivity and can take many taxpayers out of the tax system completely. This has been used in nearly all flat rate income tax countries. Jamaica’s allowance exempts over one third of the employed population. Estonia allows a personal exemption plus additional exemptions for children as does Russia.

The Western versions of the flat tax typically include a personal allowance. For example, the Hall-Rabushka flat tax proposal falls on businesses and households and allows a personal exemption. It is designed to avoid taxing savings and thus, resembles a consumption tax, such as VAT, more than a traditional income tax, which is typically also levied on returns to savings, including interest and dividends. The Fair Tax proposal in the U.S. allowed a “family consumption allowance” that was geared toward relieving the burden of a consumption tax for basic necessities.

For the transition countries, without a long tradition of tax policy or compliance, the flat tax appears to proving to be a useful ‘simplification’. But for countries such as the US or UK with a mature tax system, the benefits of simplification come less from reducing the number of brackets (Flat rate income tax) than reforming the system of allowances and exemptions. So, it is probably not worthwhile to undergo the costs of a significant tax reform only for a unification of rates.

- **Elimination of additional tax allowances and deductions**

A further principle is that simplicity will be achieved by removing allowances, credits and deductions – not by having a single rate. However, the exemptions/allowances are considered key to the fairness of many Western European systems. A tax reform in many countries that seeks to eliminate deductions for home mortgages, allowances for cars, catastrophic medical expenses and the like, is likely to meet huge opposition. In developing nations, these types of allowances and deductions can also be entrenched. Jamaica’s pre-1986 income tax had 17 types of credits and 44 allowances in the income tax system. Lobbyists fought hard to keep them in the system but were somewhat persuaded by the perceived fairness of a flat rate income tax system and relented much of their opposition (Bahl, 1991). The simplicity of a flat rate income tax reform largely hinges on the ability to get these items out of the tax system—which may be no easy task in developing or developed countries.

### **Summary and Conclusions**

The policy world’s interest in flat taxes is likely to continue given the number of countries considering flat taxes and the level of debate in the developed world regarding flat taxes. To date, however, international experience with flat rate taxes are mostly with flat rate *income* taxes. These types of taxes may be successful simplifications of the income tax system, and may in fact give rise to increased revenues through increases in compliance and easier administration. However, there is little documented evidence that this is the case and it may be simply too difficult to disentangle from other changes occurring in the countries’ tax systems and their economies.

Flat rate income taxes do not necessarily, even theoretically, yield increases in economic growth. For taxes to have an impact in an economy, they must actually be imposed, administered, and collected. A very high marginal tax rate that is never imposed on a taxpayer may be no more a deterrent to economic growth than a very low marginal tax rate that is or is not administered. The empirical evidence on the effect of the existing flat rate income tax cases on economic and revenue growth is mixed. This is because each flat rate income tax system is unique and each was born out of a different pre-reform system. The economic impacts are driven by the effect of a tax reform on changes in relative prices that affect economic agents (the cost of consumption versus savings, take home pay, the net return to an investment). Since each country starts from a different position regarding how it taxes these factors, a change to a flat rate income tax will affect each country differently.

Finally, most flat rate income taxes are not flat. As discussed in this note, most countries utilize some form of standard deduction or personal exemption that effectively eliminates



some taxpayers from the tax rolls. The decision regarding the “correct” level of progressivity or redistribution from the income tax system is in the purview of each government. It is obvious that the countries reviewed felt that vertical equity was an issue that needed to be specifically addressed under the flat rate income tax.

Table 1: Comparison of Flat Taxes

Region/Country	Year PIT Introduced	Flat Tax on			Exemptions	Comments/ Former Top Rate
		PIT	CIT	Consump/VAT		
<b>Transition</b>						
Estonia <sup>1</sup>	1994	26/2	26 <sup>2</sup>	-	\$1000	
Georgia	2004/5	12	12	-		33 PIT; 35 CIT
Latvia	1995	25	15 <sup>3</sup>			20 PIT; 20 CIT
Lithuania <sup>4</sup>	1994	33	15		\$1200 + others	37 PIT; 45 CIT
Romania	2005	16	16	-		40 PIT; 25 CIT
Russia	2001	13	24 <sup>5</sup>			35 PIT; 35 CIT
Serbia	2003	14	14			40 PIT; 34 CIT
Slovakia	2004	19	19	19	Pensions and contributions to NGOs	38 PIT; 25 CIT
Ukraine <sup>6</sup>	2004	13	-	-		90 PIT; 35 CIT
Poland	2004	-	19			40 PIT; 30 CIT
<b>Others</b>						
Jersey	1940	20	20	-	Family allowance	
Guernsey	1960	20	20	-	Business expenses	
Hong Kong	1947	16	-	-	Optional	
Iraq	2003	15	15	-		45 PIT & ITC
Jamaica	1986	33.5	33.5			57.5 PIT; 45 CIT
Paraguay	2005	10				

<sup>1</sup> In 2005, Estonia passed legislation to reduce the flat rate by 2 percentage points for each year through 2007, i.e., to 20%. Personal exemptions were also increased to over \$2000 in 2005.

<sup>2</sup> In 2000, corporate retained earnings were exempted from tax.

<sup>3</sup> 2004

<sup>4</sup> In 2005, the PIT was reduced to 29% and to 27% with effect from July 1, 2006 and 24% from January 1, 2008. A 15% flat rate remains on royalties, interest and other sources of income.

<sup>5</sup> 2002, a reduced corporate tax, not a flat tax.

<sup>6</sup> On January 1, 2005, Ukraine began taxing dividends and interest on bank deposits at 5%. The corporate rate was reduced but is not flat.

**Table 2: Comparison of Flat Tax Rates and Top Rates on Personal Income Tax: Europe and the Transition Countries (Marginal Rates)**

0-9%	10-19%	20-29%	30-39%	40-49%	50%+
Bosnia-Herzegovina	<b>Georgia (12)</b>	Albania	<b>BELARUS*</b>	Britain	Austria
	Macedonia	Bulgaria(10)	Cyprus	<b>CROATIA(15)</b>	Belgium
	<b>Iraq (15)</b>	Denmark	Czech Rep.(15)	Germany (25-30)	France
	<b>Romania (16)</b>	<b>Estonia (26)</b>	Finland	Greece(25)	Netherlands
	<b>Russia (13)</b>	<b>Latvia (25)</b>	Hungary (20)	Ireland	Norway
	<b>Serbia (14)</b>	Moldova	<b>Lithuania (33)</b>	Italy	Slovenia (20)
	<b>Slovakia (19)</b>		Luxembourg	<b>Poland (15)</b>	Sweden
	<b>Ukraine (13)</b>		Malta	Portugal	
			Monaco	Spain (30)	
				Turkey	

Notes:

Countries with flat taxes are shown in bold and the rate in parentheses.

Countries that are or have considered the introduction of flat taxes are shown in italics and the proposed PIT rate in parentheses.

\* Plans to harmonize its tax code with Russia (Edwards, 2005).

**Table 3: Taxes as a Share of GDP (1990s average, select countries)**

Country	%	Country	%	Country	%
Albania	20.1	Georgia	8.81	Nigeria	7.83
Argentina	19.76	Germany	37.27	Norway	40.7
Armenia	15.07	Ghana	13.02	Panama	18.57
Australia	27.76	Greece	32.09	Paraguay	9.41
Austria	42.02	Guatemala	7.71	Peru	14.47
Azerbaijan	21.5	Hungary	41.39	Philippines	15.29
Bangladesh	7.49	Iceland	32.72	Poland	38.76
Belarus	42.59	India	14.54	Portugal	31.14
Belgium	44.5	Indonesia	15.76	Romania	30.17
Benin	10.03	Ireland	32.04	Russian Federation	30.23
Bhutan	6.1	Israel	35.95	Rwanda	8.03
Bolivia	14.58	Italy	41.95	Sao Tome and Principe	10.97
Bosnia and Herzegovina	29.7	Jamaica	24.01	Senegal	15.39
Botswana	33.8	Japan	28.06	Seychelles	34.38
Brazil	26.77	Kazakhstan	15.67	Sierra Leone	11.23
Bulgaria	32.8	Kenya	22.38	Singapore	16.33
Burkina Faso	9.88	Korea, Rep.	20.86	Slovak Republic	37.13
Burundi	15.18	Kyrgyz Republic	14.06	Slovenia	41.04
Cameroon	9.6	Latvia	32.51	South Africa	25.57
Canada	37.24	Lesotho	39.2	Spain	32.45
Cape Verde	16.28	Lithuania	30.13	Sri Lanka	17.35
Central African Republic	8.38	Luxembourg	40.92	Sudan	6.28
Chad	6.58	Macedonia, FYR	37.82	Swaziland	29.68
Chile	19.64	Madagascar	8.15	Sweden	49.47
China	12.58	Malawi	15.52	Switzerland	32.81
Comoros	12.23	Malaysia	20.54	Syrian Arab Republic	17.59
Congo, Rep.	13.27	Mali	10.68	Tajikistan	23.39
Costa Rica	21.17	Malta	26.82	Tanzania	13.27
Cote d'Ivoire	16.73	Mauritania	17.57	Thailand	17.2
Croatia	44.53	Mauritius	19.22	Togo	13.52
Czech Republic	37.12	Mexico	16.42	Trinidad and Tobago	23.2
Denmark	48.49	Moldova	26.18	Turkey	24.37
Dominican Republic	13.54	Mongolia	25.15	Turkmenistan	12.96
Equatorial Guinea	12.67	Mozambique	17.97	Uganda	8.76
Estonia	34.97	Namibia	30.15	Ukraine	36.29
Ethiopia	10.37	Netherlands	43.24	United Kingdom	34.57
Finland	38.07	New Zealand	33.74	United States	27.05
France	42.48	Nicaragua	25.55	Uzbekistan	27.89
Gambia, The	19.88	Niger	6.72	Zambia	17.49
				Zimbabwe	23.62

Source: IMF Government Finance Statistics and the World Bank, World Development Indicators

**Table 4: Income Tax Share of Total Tax Revenue, Select Countries (2000)**

Country	Share (%)	Country	Share (%)
Argentina	18.7	Mauritius	13.1
Bahrain	16.4	Mexico	38.1
Belarus	11.7	Moldova	4.1
Bhutan	53.4	Mongolia	16
Bolivia	9.9	Myanmar	34.5
Bulgaria	14.6	Nepal	21
Canada	58.6	Nicaragua	14.1
Chile	22.9	Pakistan	28.1
Congo, Dem. Rep.	12.6	Panama	29.4
Congo, Rep.	11.3	Paraguay	17.9
Costa Rica	14.5	Peru	24.8
Cote d'Ivoire	24.6	Poland	20.9
Croatia	9.5	Romania	14.8
Czech Republic	13.8	Russian Federation	13.7
Denmark	40.2	Seychelles	22
Dominican Republic	19.6	Singapore	50.2
Estonia	15.8	Slovak Republic	20.7
Georgia	8.8	Slovenia	14.9
Hungary	22.3	South Africa	56
India	37.3	Switzerland	17.7
Iran, Islamic Rep.	41.7	Tajikistan	3.4
Israel	45.7	Thailand	33.8
Jamaica	41.9	Tunisia	22.3
Kazakhstan	31.2	Turkey	37.4
Latvia	13.5	Ukraine	15.2
Lithuania	12.9	United States	61.3
Macao, China	9	Uruguay	16.9
Madagascar	15.7	Venezuela, RB	40.3
Maldives	4.6		
Median		18.7	
Mean		23.8	

Source: IMF, Government Finance Statistics (2000).

**Table 5: Key Economic Indicators in Countries with Flat Tax – Before and After**

Country	Year PIT Introduced	PIT rate	GDP Growth % p.a.		FDI (US \$ m.)		Shadow economy % of GDP	
			Before (3-year average)	After 1 <sup>st</sup> year 2 <sup>nd</sup> year	Before (3-year average)	After 1 <sup>st</sup> year 2 <sup>nd</sup> year	Before	After
<b>Transition</b>								
<b>Estonia</b> <sup>1</sup>	1994	26/22	-11.7	-1.6 4.5	118 <sup>9</sup>	214 202	33.9 <sup>5</sup>	38.5 <sup>5</sup> 39.1 <sup>7</sup>
<b>Georgia</b>	2004/5	12	7.1	6.2	205		66.1 <sup>7</sup>	
<b>Latvia</b>	1995	25	-11.6	-0.9 3.8	96	180 382	34.8 <sup>6</sup>	39.6 <sup>7</sup>
<b>Lithuania</b> <sup>2</sup>	1994	33	-14.4	-9.8 3.3	30 <sup>10</sup>	31 73	26 <sup>5</sup>	25.2 29.4 <sup>7</sup>
<b>Romania</b>	2005	16	5.8	4.1	1,494 <sup>9</sup>		33.4 <sup>7</sup>	
<b>Russia</b>	2001	13	10.0	5.1 4.7	2,929	2,469 3,461	46.1	45.1 <sup>7</sup>
<b>Serbia</b>	2003	14	4.0	3.0	222	1,360		
<b>Slovakia</b>	2004	19	4.9	5.75	2,093 <sup>9</sup>	1,707	26.7 <sup>7</sup>	
<b>Ukraine</b> <sup>3</sup>	2004	13	7.9		970		51.2 <sup>7</sup>	
<b>Poland</b>	2004	-	2.1		4,123		27.4 <sup>7</sup>	
<b>Others</b>								
<b>Jersey</b>	1940	20						
<b>Guernsey</b>	1960	20						
<b>Hong Kong</b> <sup>4</sup>	1947	16						16.6 <sup>8</sup>
<b>Iraq</b>	2003	15						
<b>Jamaica</b>	1986	33.5	-1.0	1.6 8.0	5	-4.6 53		49.6 <sup>8</sup>
<b>Paraguay</b>	2005	10	3.2		92.5			

Notes:

<sup>1</sup> In 2005, Estonia passed legislation to reduce the flat tax rate by 2% (percentage points) for each year through 2007 i.e. to 20%. Personal exemptions were also increased to over \$2000 in 2005.

<sup>2</sup> In 2005, the PIT was reduced to 27% from July 1, 2006 and to 24% from January 1, 2008. A 15% flat rate remains on royalties, interest and other sources of income.

<sup>3</sup> On January 1, 2005, Ukraine began taxing dividends and interest on bank deposits at 5%. The corporate rate was reduced but is not flat.

<sup>4</sup> Hong Kong has an optional dual system whereby taxpayers can elect to opt for flat tax payments at 16%.

<sup>5</sup> 1990-93 average

<sup>6</sup> 1994-95 average

<sup>7</sup> 2000-01 average

<sup>8</sup> 1999/00 average

<sup>9</sup> 2-year average

<sup>10</sup> FDI net inflows (BoP current US\$)

Sources: GDP and FDI – *World Development Indicators* and Various reports

Shadow Economy – Friedrich Schneider Discussion Papers (June 2002 and March 2004), Global Development Network

## **Appendix 1: Country Experience with the Flat Rate Income Tax**

### **Estonia**

In 1994, Estonia taxed labor and capital at the same rate. Beginning in 2000, profits were not taxed until distributed to shareholders as dividends, providing corporations an incentive to retain earnings and re-invest. Corporate taxes in Estonia account for a small portion of total tax revenues (less than 4 percent).

Following the 1994 reform, growth in Estonia has been impressive – reaching double digits in 1997, and has since averaged about 6 percent annually. Significantly, the reform did not erode the tax base – in 1993, general government revenues were 39.4 percent of GDP and in 2002, 39.6 percent. Estonia's gross foreign direct investment (FDI) inflows reached a high of around 12 percent of GDP in the first half of 2005, up from 10.2 percent in 2003. In a bid to maintain the high FDI inflows, Estonia decided to engage in tax competition and reduce its level of taxation to avoid losing business to neighboring countries. Beginning in 2005, Estonia began to reduce the flat tax rate by 2 percent per year until 2007 (i.e. to 20 percent). Simultaneously, personal exemptions were increased to \$2000.

However, as in many of the transition countries, income tax revenues are less important than VAT. In Estonia, in 1993, personal income taxes raised revenues equivalent to 8.2 percent of GDP and in 2002, 7.2 percent, compared to 9.4 percent for VAT. Similarly, as in other transition countries (for instance, Slovakia), the high rates of VAT, rather than the flattening of income taxes, is what sustains government revenues.

### **Hong Kong**

Hong Kong has a flat tax of 16% but this is subject to large personal exemptions for those with children of dependent parents. Hong Kong also generates a lot of its tax revenue through the relatively high property tax, which is an annual 16 percent tax on net assessable value of a property (or how much the property could be rented for).

### **Iraq**

A 15 percent flat rate income tax was introduced in Iraq by the Coalition Provisional Authority Order #37, "Tax Strategy for 2003." The tax was implemented on January 1, 2004. As noted by Rabushka (2004), the magnitude of the income tax is expected to be very small for the coming years (0.02 percent of expenditures in 2004).

### **Lithuania**

Lithuania was the second Baltic country to introduce a flat tax system by implementing a relatively high personal income tax rate of 33 percent and reducing the corporate tax from 24 percent to a low 15 percent rate. Lithuania's post-Soviet economy was characterized by highly depressed incomes, rigid market structures, high inflation and swelling budget deficits, among other economic and financial shocks. The flat tax system allows for generous personal exemptions while on the corporate side, it exempts personal real estate from capital gains and taxes other capital gains at a reduced 10 percent. While not possible to correlate to growth with tax reform, immediately following adoption of the

flat tax, the GDP per capita continued to fall, but quickly began to turn upwards, realizing the fastest growth GDP in the Baltic region in 2002 at 6.8 percent, and subsequently, 9.8 percent and 6.7 percent<sup>14</sup> in 2003 and 2004 respectively.

Lithuanian personal income tax law makes a distinction between income from one's principal place of employment, which is taxed at a flat rate after extensive deductions, and income from supplemental sources, which is taxed according to a progressive schedule of brackets ranging from 10 percent to 35 percent. The lowered flat tax rate in 2003 was accompanied by the introduction of a 1.5 percent real estate tax. Gifts and inheritances are taxed at 0 percent, 5 percent and 10 percent depending on the amount involved.

## **Russia**

The Russian Federation overhauled its tax structure in 2001 by moving from a progressive income tax to a flat rate income tax and also broadening its tax base. Russia replaced its three-bracket personal income tax system with a flat tax rate of 13 percent and reduced its corporate tax from 35 percent to 24 percent. The flat tax exempts income below 4,800 rubles. The new tax code also altered the structure of social insurance payments significantly, with the employers' contributions being reduced from 38.5 percent<sup>15</sup> to marginal rates ranging between 35.6 percent and 5 percent, with the lowest rate applying to salaries in excess of 600,000 rubles. The system did retain differential treatment of capital income and included a number of allowances for children, pensioners and veterans among others.

In the first year after Russia introduced the flat personal income tax, revenues increased by 25 percent in real terms and doubled in 2004. Real GDP growth averaged 5.5 percent during the 3-year period to 2003 and Russia ended 2005 with its seventh straight year of growth, averaging 6.4% annually since the financial crisis of 1998.

Russia's flat rate income tax has received increasing attention due to the significant increases in revenue post flat tax reform. Ivanova et. al.(2005) find that the strongest increases in tax payments came from individuals least affected by the marginal tax rate

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<sup>14</sup> The slight reduction in real GDP growth was attributed to an unfavorable external environment, notably stagnating EU markets. However, real GDP growth remained robust at 6.7 percent in 2004, making the country the second fastest-growing economy in the EU (World Bank, 2005, "Country Brief 2005: Lithuania.")

<sup>15</sup> Before the tax reforms, separate contributions were paid to the pension, social medical and employment funds at a combined rate of 38.5 percent on the employer and one percent on the employee and it was applied at all income levels. After the reforms, a single unified social tax was charged on the employer.



changes of the flat tax reform and therefore conclude that the flat tax reform itself may have not had a large impact on the increase in tax revenue in the Russian Federation.

## **Slovakia**

Slovakia introduced a flat tax of 19 percent in 2004 that applies to personal income, corporate income and VAT – the closest of any country to a ‘comprehensive’ flat tax system. Under this system, all personal income up to 1.6 times the poverty line is exempt from taxation. Before the reform, Slovakia had an extremely complicated tax code with, inter alia, five brackets ranging from 10 percent to 38 percent and 90 different exemptions; 27 items had their own specific tax rates, and the system underwent frequent tax rate changes (often twice a year). The new system taxes profits on businesses, but not the dividends they distribute and as such, is close to the Hall-Rabushka model.

Overall, the Slovakia tax reform package is ambitious and was supposedly intended to create a competitive and non-distortionary market environment (Durajka 2005). Although too early to conclude, the outcomes of the tax reform, coupled with other simultaneous, structural reforms appear favorable<sup>16</sup>. For instance, Slovakia was named the ‘Top Economic Reformer’ by the World Bank in 2004, primarily due to its comprehensive tax reform, which has coincided with improved compliance and increased FDI. There is also broad support within the country for the simplicity and transparency of the new code. The high payroll tax, however, is a notable drawback to the tax system: social security contributions of employees and employers amounted to almost one half of labor income in 2004, providing an incentive to convert labor income into business income and to drive economic activity into the shadow economy.

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<sup>16</sup> While the share of income as a percentage of GDP was expected to fall to 4.9 percent in 2005 from 6.5 percent in 2003, VAT revenue was estimated to go up to 8.3 percent from 7.0 percent over the same period. Real GDP growth rose to 5.5 percent in 2004 up from 3.9 percent in 2003 and it is forecast at 5.3 percent in 2005 and at 5.7 percent in 2006.

## **Appendix 2: Summary of Some U.S. Flat Tax Proposals**

### **The Hall-Rabushka Flat Tax Proposal**

Hall and Rabushka (1985)<sup>17</sup> proposed a new tax system for the United States that has a broad base and a surprisingly low rate of 19 percent. The tax was the consumption based flat-tax that we referred to earlier as the “definition” of a flat tax. The Hall-Rabushka tax system introduces progressivity by using a generous personal allowance.<sup>18</sup> Their original plan proposed a personal allowance of \$16 500 for a married couple filing jointly, \$9 500 for singles and \$14 000 for single heads of household. Their system is based on a very basic administrative principle that income should be taxed only once and as close as possible to its source. When comparing their proposed system with the one currently in place to compute the 1983 tax revenue from corporate income, Hall and Rabushka found that with a corporate tax rate of 46 percent, \$44 billion was raised while their 19 percent flat tax would have raised \$129 billion. Their wage-salary tax on the other hand, would have yielded only \$206 billion in 1983 as opposed to the much higher \$290 billion raised. They argue that the substantial revenue that the government would receive from the flat business tax would compensate for the reduced revenues from the flat wage-salary tax.

### **The Forbes’ Plan**

Another strong endorser of the flat tax in the US is Steve Forbes<sup>19</sup> (Forbes 2005), whose flat tax proposal is quite similar or based on the Hall-Rabushka system. He recommends a fair and simple flat tax system to replace the current federal income tax code and whose return would be a single sheet of paper or postcard. The Forbes tax would be a single-rate federal income tax and corporate tax of 17 percent with income taxed at its source or as close to the source as possible. There will be no double or triple taxation, i.e., income will be taxed once and only once. He proposes generous and refundable exemptions for the following groups: adults (\$13,200 standard exemption); married couples (\$26,400

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<sup>17</sup> For Hall and Rabushka though, the starting point was December 10, 1981 when they first published in the Wall Street Journal their proposal to replace the federal tax system with a flat tax and a simple tax form that would fit on a postcard (Hall, R. E. and A. Rabushka (1983). Low Tax, Simple Tax, Flat Tax. New York, McGraw-Hill Book Company.

<sup>18</sup> They proposed personal allowances of up to \$25 500 for a family of four in 1995.

<sup>19</sup> Steven Forbes offered the flat tax proposal in the 1996 presidential primaries as a presidential candidate.

deduction); and families (\$4,000 exemptions for each child or dependent, including a refundable tax credit of \$1,000 per child under 16). His proposal also allows for the retention of the Earned Income Tax Credit (EITC) and does away with taxes like the 'death' tax, social security tax, among others. His flat tax is not mandatory, tax payers are free to stick with the old system.

### **The Armey-Shelby Plan**

Taking the flat tax debate a step further, two congressmen, Richard Armey and Richard Shelby sponsored a bill that was introduced as legislation in 1994 and 1995, and revised in 1997<sup>20</sup>. The Armey-Shelby flat tax plan was based on the Hall-Rabushka proposal whereby they would establish a single 17 percent<sup>21</sup> tax rate on a much broader base by doing away with the current five brackets and removing virtually all deductions, exemptions, credits and exclusions.

### **The X-tax**

The "X-tax" is a variant of the H-R flat tax that introduces a progressive marginal tax rate structure for individuals; the business tax rate is the same as the highest individual tax rate.<sup>22</sup>

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<sup>20</sup> The first person to introduce the Hall-Rabushka flat tax proposal as a bill in Congress though was Senator Dennis DeConcini on March 1, 1982 (Calegari, M. (1998). "Flat Taxes and Effective Tax Planning." National Tax Journal **LI** (4): 689-713.

<sup>21</sup> The Armey-Shelby flat tax plan set the rate at 20 in 1996-97 and 17 percent thereafter (Aaron, H. J. and W. G. Gale, Eds. (1996). Economic Effects of Fundamental Tax Reform. Washington, D.C., Brookings Institute Press.

<sup>22</sup> The "X-tax" proposal is attributed to David Bradford (1986). A helpful summary of the flat tax and X-tax proposals is available from the President's Advisory Panel on Tax Reform: <http://www.taxreformpanel.gov/>.

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